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SUPREME COURT, U. S.

Nos. 395 and 410

In the Supreme Court of the United States

OCTOBER TERM, 1957

UNITED STATES OF AMERICA, PETITIONER

v.

MOLLY G. BESS

MOLLY G. BESS, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOHN F. DAVIS,
Assistant to the Solicitor General,
A. F. PRESCOTT,
KENNETH E. LEVIN,
Attorneys,
Department of Justice, Washington 25, D. C.

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OPINIONS BELOW

The opinion of the District Court (R. 10–16) is reported at 134 F. Supp. 467. The opinion of the Court of Appeals (R. 17–22) is reported at 243 F. 2d 675.

JURISDICTION

The judgment of the Court of Appeals was entered on March 28, 1957 (R. 23). On May 20, 1957, the

petition of Molly G. Bess for rehearing was denied (R. 28). On June 21, 1957, by order of Mr. Justice Brennan, the time for filing a petition for certiorari on behalf of the United States was extended to and including August 23, 1957 (R. 30). The petition of the United States was filed on August 22, 1957. The petition of Molly G. Bess was filed on August 29, 1957. The writs were granted on October 28, 1957 (R. 31–32). The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTION PRESENTED

Whether, for the purpose of collecting federal income taxes and particularly those as to which a lien attached on decedent's property before his death, the beneficiary of life insurance policies, in which the decedent had retained the right to change the beneficiary and to draw, or borrow against, the cash surrender values, is liable to the Government to the extent (1) of the entire proceeds of the policies, or, alternatively, (2) of the cash surrender values.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are: Sections 311 (a) and (f), 811 (g), 827 (b), 900 (a) and (e) and 3670 of the Internal Revenue Code of 1939; Section 316 of the Revenue Act of 1926; Sections 34–28 and 34–29 of 17 New Jersey Statutes Annotated; Section 81.27 of Treasury Regulations 105; and Section 29.311–1 of Treasury Regulations 111.

Section 3670 of the Internal Revenue Code of 1939 provides:

Property Subject to Lien

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

(26 U. S. C. 3670.)

17 New Jersey Statutes Annotated (Permanent ed.) provides:

17:34–28. *Beneficiary's right to proceeds*

When a policy of insurance is effected by any person on his own life, or on another life in favor of a person other than himself having an insurable interest therein, the lawful beneficiary thereof, other than himself or his legal representatives, shall be entitled to its proceeds, against the creditors and representatives of the person effecting it. The person to whom a policy of life insurance is made payable may maintain an action thereon in his own name. Subject to the statute of limitations, the amount of any premiums for the insurance paid in fraud of creditors, with interest thereon, shall, however, inure to their benefit from the proceeds of the policy, but the company issuing the policy shall be discharged of all liability thereon by payment of its proceeds in accordance with its terms, unless, before the payment, the company shall have written notice by or in behalf of some creditor, with specification of the amount claimed, claiming to recover

for certain premiums paid in fraud of creditors.

17:34–29. *Policies to inure to benefit of married woman*

Every policy of life insurance made payable to or for the benefit of a married woman, or after its issue assigned, transferred or in any way made payable to a married woman, or to any person in trust for her or for her benefit, whether procured by herself, her husband or by another person, and whether the assignment or transfer is made by her husband or by another person, shall inure to her separate use and benefit, and to that of her children, according to the terms and provisions of the policy or assignment, subject to the foregoing provisions relating to premiums paid in fraud of creditors.

The remainder of the statutes and regulations referred to above are set out in the appendix to the Government's brief in *Commissioner of Internal Revenue* v. *Stern*, No 311, this Term.

STATEMENT

Herman Bess, husband of Molly G. Bess, died on June 29, 1950 (R. 3), leaving an insolvent estate (R. 5, 22).

Prior to Mr. Bess's death, the Commissioner had assessed against him on July 30, 1948, a deficiency for the year 1945 in the total amount of $11,514, consisting of $10,119.31 additional income tax plus $1,421.69 interest thereon. On the same date, the Commissioner assessed a deficiency for the year 1946 of $3,789.32, consisting of $3,507.03 additional tax

and $282.29 interest. In each case, notice and demand were made on decedent. (R. 4.) On August 24, 1950, the Commissioner assessed a deficiency for the year 1947 of $925.94, consisting of $813.22 additional tax and $112.72 interest thereon. Notice and demand were made on decedent's estate. (R. 5). Herman Bess made partial payment of the deficiency for 1945 prior to his death, and his executrix made some additional payments thereafter, leaving $4,159.31 plus interest due and unpaid for that year. No part of the amounts due for 1946 and 1947 has been paid. (R. 4–5.)

At the time of his death, Herman Bess carried eight insurance policies on his life with a total cash surrender value, as reduced by outstanding loans, of $3,362.53, and total proceeds of $63,576.95 (R. 7–10). Molly G. Bess was the beneficiary of those policies (R. 7). On all of them, Mr. Bess had paid the premiums (R. 9) and had retained the right to change the beneficiary (R. 7–9). Except for policy No. 8, a group insurance policy, Bess had retained the right to draw the cash surrender values or borrow against them and to assign the policies (R. 7–9).

By reason of the death of Herman Bess, Molly G. Bess as beneficiary of the policies became entitled to be paid according to their terms and has in fact received a total sum of $69,576.95 (R. 9).[1]

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[1] This is the stipulated figure with no indication in the record as to why the beneficiary received $6,000 more than the $63,576.95 provided in the policies. The correctness of the figure is not important to the case.

The District Court held that Molly G. Bess was liable as a transferee of the proceeds of decedent's insurance policies for the entire amount of decedent's delinquent income taxes (R. 10–16). The Court of Appeals vacated the judgment of the District Court, and held that Molly G. Bess was liable as a transferee only to the extent of the cash surrender values of the policies (R. 17–23).

SUMMARY OF ARGUMENT

This proceeding was brought in equity by the United States to enforce transferee liability against Molly G. Bess as beneficiary of the life insurance policies of her deceased husband, Herman Bess, who died owing delinquent income taxes and whose estate is insolvent. Except that for two of the three years here involved the Government has a tax lien on all the property and rights to property of the insured prior to his death, the facts in the instant case do not differ materially from those in the companion case of *Commissioner of Internal Revenue* v. *Stern*, No. 311, this Term. In the present case, the Government proceeded against the beneficiary in equity rather than by the summary method authorized by Section 311 of the Internal Revenue Code of 1939 which was followed in the *Stern* case. Since Section 311 added nothing of substance to transferee liability, the question whether the beneficiary here is liable as a transferee, and to what extent, must be decided upon the same principles asserted by the Government in its brief in *Stern*. Rather than restating that argument in detail here, we respectfully refer the Court to our brief in that case.

Although New Jersey law holds, unlike Kentucky, that the interest of the beneficiary of insurance policies is "vested," the New Jersey cases show plainly that, where the insured reserves the rights retained by the insured here, the so-called "vested" interest of the beneficiary is subject to defeasance and is no greater than the mere "expectancy" involved in the *Stern* case. Thus, the beneficiary here had no more actual rights in the policies prior to the death of the insured than did the beneficiary in *Stern*. Furthermore, since the New Jersey statute relied on by the beneficiary here is, like the Kentucky statute in *Stern*, an exemption statute, it is clearly not available to limit the beneficiary's liability, for the reasons stated in our brief in *Stern*.

This case presents one additional ground, not involved in the *Stern* case, for refusing to recognize the exemption provided by state law. Here, the Commissioner in two of the years involved assessed the deficiencies and gave notice and demand for payment to the original taxpayer before his death. Under Section 3670 of the Internal Revenue Code of 1939, *supra* p. 3, a lien thereupon attached to "all property and rights to property" of the taxpayer. Therefore, if, as we urge, the beneficiary of the policies was the transferee of the proceeds or of the cash surrender values of those policies, they came to her subject to an existing lien. It is well established that state law will not be permitted to destroy a federal lien. Even those courts which have not looked with favor upon following the proceeds or cash surrender values of insurance generally have permitted it when a lien has

attached during the insured's life. *United States* v. *Behrens*, 230 F. 2d 504 (C. A. 2), certiorari denied, 351 U. S. 919; *United States* v. *Hoper*, 242 F. 2d 468 (C. A. 7).

ARGUMENT

I

Regardless of state exemptions, the beneficiary of life insurance policies as to which the insured retained certain rights is liable as a transferee either as to the entire proceeds or, alternatively, as to the cash surrender values

In the companion case of *Commissioner of Internal Revenue* v. *Stern*, No. 311, this Term, the Government urged that the beneficiary of life insurance policies, as to which the insured had reserved the rights to change the beneficiary and to draw, or to borrow against, the cash surrender values, is liable for the insured's delinquent income taxes as a transferee, either as to the entire proceeds or, alternatively, as to the cash surrender values. The facts in this case do not differ materially from *Stern* except that here the Government had a tax lien for two of the three tax years involved on all the property and rights to property of the insured prior to his death. In the next portion of this brief, we urge that this factor presents an additional basis for our argument that the state exemption law is inapplicable.

The procedure followed by the Government in the two cases also differs. In *Stern*, the Government proceeded against the beneficiary under the provisions of Section 311 of the Internal Revenue Code of 1939. It asserted a deficiency against the beneficiary who thereupon petitioned the Tax Court for a

redetermination. In the present case, the Government did not proceed against the beneficiary by the summary method authorized in Section 311, but rather brought an action against her in equity, as it had the right to do. *Leighton* v. *United States*, 289 U. S. 506. As set forth in more detail in the *Stern* brief, Section 311 added nothing of substance to transferee liability, so the question here of whether the beneficiary is liable as a transferee, and to what extent, must be decided upon the same principles asserted by the Government in its brief in *Stern*.

Essentially, our position in both cases is that, because the insured decedents retained the right until their deaths to change the beneficiaries of their life insurance policies and could, therefore, have made their estates the beneficiaries, the designation of the wives as beneficiaries, coupled with the non-exercise of the right to change the designation to their estates, made the wives transferees of the entire proceeds of the policies, and liable as such for the decedents' delinquent taxes. Alternatively, we argue that, since the insureds retained the right to draw, or to borrow against, the cash surrender value of their policies (with the exception of one policy in this case), those values were assets belonging to them. In this respect the court below upheld the Government's position, ruling that the cash surrender value of a policy is not wiped out by the death of the insured but merges into the proceeds and is subject to transferee liability on the basis of general federal law. Rather than restate the arguments in full, we respectfully refer the Court to our brief in the *Stern* case.

Unlike Kentucky (*Metropolitan Life Ins. Co.* v. *Tye*, 288 Ky. 750; *Hoskins* v. *Hoskins*, 231 Ky. 5), New Jersey holds that the interest of the beneficiary of a life insurance policy is "vested." *Metropolitan Life Ins. Co.* v. *Woolf*, 138 N. J. Eq. 450; *Prudential Ins. Co. of America* v. *Swanson*, 111 N. J. Eq. 477. The decisions show, however, that where the insured reserves the rights retained by the insured here, the so-called "vested" right of the beneficiary is subject to defeasance, an interest actually no greater than the mere "expectancy" involved in the *Stern* case. *Phœnix Mut. Life Ins. Co.* v. *Connelly*, 188 F. 2d 462 (C. A. 3). In that case the insured had retained the right to change the beneficiary and to assign the policy. Without changing the beneficiary, the insured assigned the policy as collateral for a loan, and the question was whether or not the assignee could recover the amount of the loan out of the proceeds of the policy even though the beneficiary's interest under state law was "vested." The court held that he could, saying (pp. 464, 465, 466):

> However, it is equally important and as clearly recognized by the courts of New Jersey that primary definition and delimitation of the interest of the beneficiary must be found in and measured by the terms of the contract of insurance out of which solely his rights arise. * * *
>
> * * * * * *

> The reservation in the policy of additional rights to the insured simply subjects the interest of the beneficiary in and from its inception to additional powers of defeasance. * * *
>
> * * * * *
>
> The act of assignment was the exercise of a power reserved to the insured by the terms of the contract to affect both his rights and those of the beneficiary. Both were subordinated to the rights of the assignee.

Thus, the beneficiary here had no more actual rights in the decedent's insurance policies before his death than did the beneficiary in the *Stern* case.

Like the Kentucky statute involved in *Stern*, the New Jersey statute, 17 New Jersey Statutes Annotated (Permanent ed.), Sections 34–28 and 34–29, *supra*, pp. 3 and 4, relied on by the beneficiary in the court below, is an exemption statute, and has been labeled as such by the New Jersey courts and the local federal courts. *Slurszberg* v. *Prudential Insurance Co.*, 15 N. J. Misc. 423, 425–426; *In re Pinals*, 38 F. 2d 117, 122 (D. N. J.), affirmed *sub nom. Smith* v. *Metropolitan Life Ins. Co.*, 43 F. 2d 74 (C. A. 3); *Greiman* v. *Metropolitan Life Ins. Co.*, 96 F. 2d 823, 825 (C. A. 3). Clearly, the New Jersey statute is an exemption statute and not available to limit the liability of the transferee here, for the reasons stated in our brief in *Stern*.

II

By reason of the assessment, notice, and demand for payment of decedent's 1945 and 1946 taxes prior to his death, a lien attached to all his property and rights to property, including his insurance, and remains enforceable against that property in the hands of the beneficiary

As pointed out above, a difference of fact exists between this case and *Stern* which, we submit, entitled the Government to recovery of decedent's tax liability for the years 1945 and 1946 on an additional ground. In *Stern*, the insured died prior to any assessments against him by the Commissioner. Here, the Commissioner assessed deficiencies against the insured prior to his death in the amount of $11,514 (consisting of $10,119.31 additional income tax plus $1,421.69 interest) for the year 1945, and the amount of $3,789.32 (consisting of $3,507.03 additional tax and $282.29 interest) for the year 1946. In each case, notice and demand were made on decedent. The deficiency for the year 1947 of $925.94, composed of $813.22 additional income tax and $112.72 interest, was not assessed until after the insured's death and is not involved in the argument made in this point. The insured made partial payment of the deficiency for 1945 prior to his death, and his executrix made some additional payments thereafter, leaving $4,159.31 plus interest due and unpaid for that year. No part of the amount assessed for 1946 has been paid.

Under Section 3670 of the Internal Revenue Code of 1939 (26 U. S. C. 3670, *supra*, p. 3), a lien attached to all the decedent's property and rights to

property by reason of the assessment, notice and demand, and nonpayment occurring prior to his death. The Government urges that this lien applied to the payments made to the beneficiary to the extent not only of the cash surrender value but also of the total proceeds.

Numerous courts have held that such a lien attaches to the cash surrender value of insurance policies, since, in accordance with our argument in *Stern*, these are clearly assets of the decedent during his lifetime. *United States* v. *Metropolitan Life Ins. Co.*, decided January 14, 1958 (C. A. 4); *Knox* v. *Great West Life Assur. Co.*, 109 F. Supp. 207 (E. D. Mich.), affirmed *per curiam*, 212 F. 2d 784 (C. A. 6); *Smith* v. *Donnelly*, 65 F. Supp. 415 (E. D. La.); *United States* v. *Ison*, 67 F. Supp. 40 (S. D. N. Y.); *United States* v. *Prudential Ins. Co. of America*, 54 F. Supp. 664 (E. D. Pa.); *United States* v. *Royce Shoe Co.*, 137 F. Supp. 786 (D. N. H.); *United States* v. *Trout*, 46 F. Supp. 484 (S. D. Cal.). We submit further, in accord with our argument in Point II of the *Stern* brief and the holding of the court below, that these surrender values are not wiped out upon the death of the insured, but rather merge in the proceeds. As a result, the lien remains attached, because the transfer of property subsequent to the attachment of a lien does not affect the lien. *Blacklock* v. *United States*, 208 U. S. 75; *United States* v. *Snyder*, 149 U. S. 210. For "it is of the very nature and essence of a lien, that no matter into whose hands the property goes, it passes *cum onere*; if this were

not the case, it would cease to be a lien." *Burton* v. *Smith,* 13 Pet. 464, 483; *Michigan* v. *United States,* 317 U. S. 338. Therefore, the surrender values merge in the proceeds with the lien attached, and the lien remains enforceable. Two Courts of Appeals have so held. *United States* v. *Behrens,* 230 F. 2d 504 (C. A. 2), certiorari denied, 351 U. S. 919; *United States* v. *Hoper,* 242 F. 2d 468 (C. A. 7).

Similarly, the lien equally attached to the entire proceeds on the same basis as we urged that the beneficiary was the transferee of the proceeds of the policy as well as the cash surrender value. It is to be noted that under the Internal Revenue Code the lien attaches not only on the "property" but also the "rights to property" of the taxpayer. The right reserved by the insured to name his estate as the beneficiary of his insurance results in the proceeds being his assets subject to the lien.[2]

The courts which have held that state law governs transferee liability, absent a federal statute, have also held that, where a federal tax lien has arisen before insured's death, the federal lien statute comes into play and the state statute must give way. *United*

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[2] In *United States* v. *Metropolitan Life Ins. Co.*, decided January 14, 1958 (C. A. 4), the court said (Slip op. 11) that when the insured's interest in insurance policies is subjected to the tax lien by levy upon the insurance company, this amounts to a seizure of such interest by the United States, and the United States, by virtue of such seizure, may exercise any right which the insured might have exercised under the policies.

States v. *Behrens*, 130 F. Supp. 93 (E. D. N. Y.), affirmed, 230 F. 2d 504 (C. A. 2), certiorari denied, 351 U. S. 919; see *United States* v. *Hoper*, *supra*.[3] This Court and others have upheld the supremacy of the federal lien against all sorts of attempts to impair it by reliance on state statute or court decision. Cf. *United States* v. *Snyder*, *supra*; *Michigan* v. *United States*, *supra*; *United States* v. *Scovil*, 348 U. S. 218; *United States* v. *City of Greenville*, 118 F. 2d 963 (C. A. 4); *United States* v. *Dallas Nat. Bank*, 152 F. 2d 582 (C. A. 5); *United States* v. *Heffron*, 158 F. 2d 657 (C. A. 9), certiorari denied, 331 U. S. 831; *Matter of Rosenberg*, 269 N. Y. 247, certiorari denied *sub nom. Rosenberg* v. *United States*, 298 U. S. 669. In *United States* v. *City of New Britain*, 347 U. S. 81, 84, the Court said: "Obviously, the State cannot on behalf of the City impair the standing of the federal liens, without the consent of Congress." More specifically, the courts have invariably held that state statutes exempting insurance cannot prevail in the face of the supremacy of the federal lien. *Kyle* v. *McGuirk*, 82 F. 2d 212 (C. A. 3); *Cannon* v. *Nicholas*, 80 F. 2d 934 (C. A. 10); *Knox* v. *Great West Life Assur. Co.*, 109 F. Supp. 207 (E. D. Mich.), affirmed

[3] A lien may also be important because it is enforceable without regard to the solvency or insolvency of the transferor of the property, whereas transferee liability presupposes insolvency on the part of the transferor following the transfer. *United States* v. *Hoper*, 242 F. 2d 468 (C. A. 7). This particular distinction need not be considered here, however, because the decedent's estate was in fact insolvent following the transfer (R. 5, 22).

per curiam, 212 F. 2d 784 (C. A. 6); *Fried* v. *New York Life Insurance Co.*, 241 F. 2d 504 (C. A. 2), certiorari denied *sub nom. Fried* v. *United States*, 354 U. S. 922; *Smith* v. *Donnelly*, 65 F. Supp. 415 (E. D. La.).

CONCLUSION

With respect to the petition of the United States (No. 395), the judgment of the Court of Appeals should be reversed. With respect to the cross-petition of Molly G. Bess (No. 410), the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
JOHN F. DAVIS,
Assistant to the Solicitor General.
A. F. PRESCOTT,
KENNETH E. LEVIN,
Attorneys.

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